INITIAL STATEMENT OF REASONS

Adoption of CCR Section 559.
Disclosure of Placement Agent Fees, Gifts and Campaign Contributions

SPECIFIC PURPOSE OF THE REGULATION:

In the fall of 2009, Assembly Bill 1584 was passed by the Legislature and signed into law. That bill added Government Code section 7513.85 which requires the California Public Employees' Retirement System (CalPERS) to adopt a policy requiring the disclosure of payments to placements agents in connection with CalPERS' investments with external managers. The proposed regulation complies with the new Government Code requirement and is intended to satisfy the requirements of the new law. Additional information regarding the Legislature's adoption of Assembly Bill 1584 is available at http://www.leginfo.ca.gov/.

The proposed regulation will add transparency to the CalPERS investment decision making process by requiring the disclosure of relationships between CalPERS managers (defined as External Managers) and placement agents and the fees paid to placement agents. The proposed regulation will help ensure that CalPERS investment decisions are consistent with investment policy and fiduciary responsibilities, increase the pool of information available to CalPERS Board members, staff and consultants when evaluating an investment opportunity, help prevent impropriety and the appearance of impropriety, and provide transparency and confidence in CalPERS investment decision-making processes.

Rationale for the proposed regulation:

Application of the Regulation. To ensure placement agent disclosure in all instances, the proposed regulation applies to new investment contracts and amendments to existing investment contracts. This provides CalPERS with full transparency as to whether its External Managers have or will pay any fees to a placement agent. With respect to existing investment contracts, the proposed regulation triggers placement agent disclosure where an amendment imposes a financial impact on the External Manager. In these types of situations, CalPERS has determined it is most likely that a placement agent might be involved in the underlying contract amendment. To further ensure placement agent disclosure in amendment situations, the proposed regulation also clarifies the different ways an investment contract can be substantively amended, e.g., by a vote or consent, etc., and to ensure that all amendments, regardless of the form, trigger the policy.

Definition of CalPERS Vehicle. When CalPERS investment constitutes a majority of a fund-of-funds committed capital it is likely that those fund-of-funds are often referred investments by CalPERS staff and that CalPERS has a strategic relationship with the fund-of-funds. Therefore, CalPERS is proposing to apply the disclosure obligations in the regulation to investments in External Managers from those fund-of-funds managers.

Definition of Placement Agent. The proposed regulation is designed to capture all persons that can be reasonably considered to be engaged in placement agent activities. Recent scandals in New York made clear that a placement agent can be compensated by becoming an officer, director, employee, or equity holder of the External Manager. To ensure that placement agents cannot avoid being subject to the proposed regulation based on type of compensation received, CalPERS proposes to cover placement agents who may be hired, employed, engaged, retained by, or otherwise acting on behalf of an External Manager. Not covering these individuals would be a loophole that could easily be used to escape compliance with the Policy. CalPERS wants to ensure that placement agents retained to solicit funds from CalPERS are covered regardless of whether they are retained by a third-party contract or otherwise. The proposed regulation does not, however, intend to define a placement agent so broadly such that every member of an External Manager that financially benefits from a CalPERS investment is within the definition of a placement agent. The proposed regulation therefore includes an exception clarifying that certain personnel with investment decision-making authority are not considered placement agents.

Section (b)(1) – Timing of Disclosure. Because of the significant penalties associated with a failure to disclose, CalPERS provides a reasonable period of time for the making of a placement agent disclosure. After discussing with staff and the time table for due diligence review, the timing set forth in section (b)(1) was selected.

Section (b)(1)(a) through (b)(1)(h) – Substance of the information in the disclosures.

CalPERS goal in drafting these sections was to obtain full disclosure of the compensation paid to a placement agent as a result of a CalPERS investment.

The proposed regulation requests information indicating whether the placement agent is utilizing personal or political connections. (See (b)(1)(b) and (b)(1)(f).) If personal or political connections are utilized, CalPERS believes that it raises the risk that investments may be made because of those connections rather than on the merits of the underlying investments. The resume requirement also helps to determine the bona fide qualifications of the individuals involved. Since some placement agents firms include dozens or even hundreds of employees CalPERS only requires a resume for disclosure where a large portion of the fees, greater than 15%, go to the individual.

The proposed regulation also requires placement agents to provide their professional designations as a source of further information. In many instances, the verification of a professional designation provides some validation that the placement agent is providing bona fide expertise as well as assurances that the placement agent is subject to significant legal requirements and regulatory oversight. (See (b)(1)(g) and (b)(1)(h).)

CalPERS determined that requiring copies of the actual agreements between an External Manager and a placement agent ensures that CalPERS and the public has 100% transparency and can validate the information provided via the disclosure forms. (See (b)(1)(e).) Based on a review of placement agent agreements voluntarily provided to CalPERS in 2010, it was clear that these agreements are complicated and not always easily summarized especially in advance of an investment decision by CalPERS.

The proposed regulation requests summary information of these agreements to help guide those reviewing the actual agreements and to provide the most material information quickly and easily. (See (b)(1)(a), (c), and (d).)

The proposed regulation is designed to isolate the compensation to be earned by a placement agent as a result of a CalPERS investment as opposed to total compensation paid to a placement agent by an External Manager, though the total can most likely be estimated by a review of the actual agreement. Some have recommended that the policy go further and that placement agent disclosure information should be provided even if the placement agent would not get paid as a result of a CalPERS investment. CalPERS has determined that there is less likelihood of corruption or the appearance of corruption if a placement agent is not getting paid as a result of CalPERS investment and that, therefore, disclosure is not necessary.

Section (b)(2) and (b)(3)) – Obligation to update and representation & warranty. Without these obligations the policy might be too weak and unenforceable. External Managers would be at liberty to provide a placement agent disclosure only once and be under no obligation to update the disclosure information if they learn of new information or otherwise have a change in circumstances with respect to their use of a placement agent that would be of interest to CalPERS.

Section (c) mirrors AB 1584.

Section (d) – Vehicle Manager Responsibilities. CalPERS believes it is important to detail Staff's and CalPERS' Vehicles Managers roles and responsibilities in implementing the proposed regulation. To ensure compliance with the proposed regulation, new investments and amendments to existing investments cannot be made without compliance with the proposed regulation's requirements.

Section (d)(3) –Being subject to the Securities and Exchange Commission (SEC) or another regulatory agency provides some protection that a placement agent is subject to certain ethical obligations, levels of oversight, and enforcement. Because CalPERS invests globally and in a broad variety of assets, CalPERS allowed for registration with the SEC, the Commodity Futures Trading Commission and similar non-U.S. regulatory authorities.

Section (d)(4) – Penalties. Without the imposition of significant penalties, CalPERS believes there may not be adequate incentive to comply with the policy given the large dollar amounts invested by CalPERS and historically earned by External Managers and Placement Agents.

Section (d)(5) – Indirect Payments. CalPERS seeks to avoid paying placement agent fees in addition to any management fee or investment advisory fees.

Section (h) – Exceptions. Because of the importance of this policy and the potential for corruption and the appearance of corruption, the ability to grant exceptions is extremely limited and exceptions must be made public.

Other general comments. CalPERS believes that transparency in its investment operations is important and that the public should, to the fullest extent possible, be given timely and full transparency.

FORMS

CalPERS has created two forms to facilitate disclosure under the proposed regulation. The forms are intended to comply with the requirements of the proposed regulation. One form is to facilitate disclosure related to new or prospective investments and the other form is intended to apply to disclosures triggered by an amendment to an existing investment contract. CalPERS seeks feedback on the forms as well as the proposed regulation.

TECHNICAL, THEORETICAL AND/OR EMPIRCAL STUDIES, REPORTS, OR DOCUMENTS

CalPERS has reviewed complaints and indictments from the Securities and Exchange Commission and the New York Attorney General as well as other news articles relating to placement agents. In addition, CalPERS has reviewed voluntary placement agent disclosures made by CalPERS External Managers in proposing the adoption of this regulation.

REASONABLE ALTERNATIVES TO THE REGULATION AND CALPERS' REASONS FOR REJECTING THOSE ALTERNATIVES:

Government Code section 7513.85 mandates adoption of the proposed regulation subject to the CalPERS Board of Administration's determination, made in good faith, that such action is consistent with the fiduciary responsibilities' of the Board of Administration as described in Section 17 of Article XVI of the California Constitution. As drafted, the proposed regulation is consistent with Board of Administration's fiduciary responsibilities. See subsection (d) of Government Code section 7513.85. As a result, no other alternatives were presented to or considered by the CalPERS Board of Administration.

EVIDENCE SUPPORTING FINDING OF NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESSES

None.

REASONABLE ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON SMALL BUSINESSES:

Given the significant public policy issues implicated by the policy, the CalPERS Board of Administration did not identify any reasonable alternatives that would lessen the impact on small businesses.